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THE EXTERNAL DEBT AND INDUSTRIAL DEVELOPMENT

Progress report by the Director-General

Summary

Presents an overview of the major developments in the external debt situation of developing countries and describes UNIDO activities relevant to the alleviation of the negative effects of the debt burden on industrial development.

CONTENTS

	Paragraphs	Page
Introduction	1	1
Chapter		
I. RECENT DEVELOPMENTS IN THE EXTERNAL DEBT CRISIS	2 - 8	1
II. RELEVANT UNIDO ACTIVITIES	9 - 19	2
III. ACTION REQUIRED OF THE BOARD	20	3

Introduction

1. In resolution GC.5/Res.9 on the external debt and industrial development, the General Conference at its fifth session requested the Director-General to ensure that in the planning, formulation and implementation of UNIDO activities the debt problems of developing countries be considered in connection with their priorities; to improve the present methods of industrial financing and apply, within the sphere of competence of UNIDO, innovative approaches and proposals for projects that aim at attenuating, inter alia, the negative effects of the external debt on industrial development; and to promote financial contributions to IDF to rehabilitate and increase the competitiveness of industry of the highly indebted developing countries. The Director-General was also requested to report on the implementation of that resolution to the General Conference at its sixth session through the Industrial Development Board. The present document is submitted in compliance with that request.

I. RECENT DEVELOPMENTS IN THE EXTERNAL DEBT CRISIS

2. During the 1980s the severity of the debt crisis posed a threat to the viability of the international financial system, mainly to commercial banks, and hampered the economic growth of many developing countries. In the mid-1990s, however, the debt crisis no longer threatens the international financial system to such a great extent. The involvement of commercial banks has been reduced considerably in some groups of developing countries, and in sub-Saharan Africa in particular, as official creditors have gradually taken the place of banks in providing funds for economic development. More importantly, however, market restructuring operations have significantly improved the capacity of developing countries, and especially of middle-income countries, to service their debt.

3. The external debt of all developing countries is now expanding more slowly and, as a result of debt restructuring operations, substantial changes in the debt profile have taken place in recent years. First, official long-term public and publicly-guaranteed debt has expanded as multilateral and bilateral donors have maintained their lending, mainly in support of the low-income developing countries, whereas lending by commercial banks to these countries has contracted sharply. Secondly, the amount of long-term debt on concessional terms has also expanded, principally because of the restructuring of non-concessional debt on concessional terms, for example, in Egypt and Poland. Thirdly, in Latin America and east Asia, the private non-guaranteed long-term debt has been steadily rising showing a renewed confidence from the international community in the economic

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potential of some middle-income developing countries.

4. Looking at all types of resource flows to developing countries, including foreign direct investment and portfolio investment, these almost doubled between 1989 and 1992, rising from $79.5 billion to $156.6 billion. Net flows of external debt (that is disbursements minus debt service) were still the largest component of external resource flows and totalled $61.8 billion in 1992. The most rapid growth, however, has been in foreign direct investment (FDI), which totalled $47.2 billion in 1992, compared with $14.5 billion five years earlier in 1987. Portfolio equity flows have also expanded rapidly, totalling $13 billion in 1992, compared with only $761 million in 1987. Currently, about 50 per cent of total FDI in developing countries goes into production and manufacturing, about 30 per cent into services and the remaining 20 per cent into agriculture and mining. Within the manufacturing sector, FDI flows are increasingly concentrated in medium and high-technology or capital-intensive industries.

5. The relative alleviation of the debt crisis is primarily due to the recovery of some Latin American countries such as Argentina, Chile and Mexico, which were classified a few years ago as severely indebted. The main concerns about the debt crisis are now focused on the severely indebted low-income countries, many of which are in sub-Saharan Africa. The debt of the highly indebted low-income countries is small in absolute terms, but alarmingly large in relation to their exports and gross national product (GNP), revealing the fundamental incapacity of those countries to service their debt. Their crisis is not just a problem of short-term liquidity but a problem of long-term insolvency caused by the limited productive base, coupled with severe foreign exchange shortages. The primary objective of the official creditors, the main and almost unique source of financial resources for these countries, has been to provide a constant flow of new concessional financing to ensure that their efforts to develop would not be frustrated by lack of access to external financial funds. This strategy has certainly kept the severely indebted low-income countries above water, but the problem of debt overhang still needs to be adequately addressed.

6. Restoring creditworthiness, i.e. the ability of a country to service its debt and attract new resources, is ultimately a matter of establishing a sustainable relationship between external borrowing and future income.

7. The debt crisis of the 1980s proved not only that the volume of external borrowing is important, but also that its management is crucial. Various types of capital inflows give rise to different terms of obligations and may lead to different growth paths. Two main categories can be considered: debt finance and equity finance. However, debt finance and equity finance must be viewed as two distinct categories since equity finance does not carry with it an obligation to repay. Consequently, there are few direct links between equity finance and the external debt situation, other than, for example, in the case of debt-equity conversions.

8. Lending by official creditors, such as international organizations, Governments and government agencies is one form of debt finance. One of its characteristics is that the rate of return on projects funded often has little relation to the interest, term or other characteristics of the credit. Thus, debt finance is considered particularly suitable for projects that bear a high economic but low financial rate of return such as in the case of infrastructure, environment, health and education projects. The technical assistance component of many industrial projects in developing countries is also frequently funded by official creditors.

II. RELEVANT UNIDO ACTIVITIES

9. Most of UNIDO's technical cooperation projects are financed by donor countries, the United Nations Development Programme (UNDP) and other international organizations such as the World Bank. A detailed summary of mobilization of financial resources for industrial development channelled through UNIDO is presented in the Annual Report of UNIDO, 1993 (IDB.12/2, chap. III, section D, and chap. VIII). Following the contraction in UNDP financing as a result of the successor arrangements, the Industrial Development Fund (IDF), which has been steadily increasing, has become the largest source of technical cooperation funds in term of approvals. In the framework of the IDF general-purpose convertible pool, specific promotional actions have been undertaken such as approval of preparatory assistance projects in support of highly-indebted countries in their efforts to rehabilitate and increase the competitiveness of their industrial sector. Based on the findings of some of these preparatory assistance projects, UNIDO succeeded in mobilizing special-purpose contributions to IDF for restructuring as well as increasing competitiveness, especially at the small and medium enterprise (SME) level, in a number of small, highly indebted Latin American countries (Bolivia, Honduras and Nicaragua).

10. UNIDO's technical cooperation activities in developing countries serve to alleviate the burden of external debt in various ways, both directly and indirectly. At the most basic level, a direct impact is made in the case of export-oriented projects, whose output generates foreign exchange earnings, part of which may be used to service the external debt. Similarly, the promotion of import-substitution industrial projects leads to indirect savings of foreign exchange. Many developing countries, however - in sub-Saharan Africa in particular - continue to be highly dependent on imports of a wide range of essential goods, including basic consumer items. Moreover, the industrial installations which do exist often continue to be highly dependent on imported inputs of raw materials, intermediate and capital goods, and replacements parts, thus perpetuating the need to raise external finance. To the extent that UNIDO assists such countries in establishing competitive production structures in various industrial sectors, this contributes both to sustainable industrial development and reduction of impact of external debt.

11. UNIDO also provides several specialized services which have a direct bearing on a country's debt servicing capacity. These include quality control, standardization and metrology which have a crucial impact on the successful marketing of industrial goods for exports, not only in the global market, but also at regional and subregional levels. In the latter case, standardization is also a vital element in the successful move towards increased regional economic integration on which

the economic future of the smaller developing countries is greatly dependent.

12. At the micro level, the UNIDO programme on enterprise restructuring provides technical guidance and support to improve efficiency and techno-economic viability of major state-owned industrial enterprises, many of which carry substantial external debt. Stemming the flow of losses from such enterprises by liquidating production operations that are no longer financially viable enables the freeing of additional funds for debt services, while the privatization of viable state-owned industrial enterprises offers potential for debt conversion schemes under which external debt obligations are, at least partially, converted into equity holdings in the privatized enterprises.

13. The debt crisis and the structural adjustment programmes on which most of the heavily indebted nations have embarked have emphasized the weakness of many national statistical services. While the first step in structural adjustment exercises has been the improvement of data collection and appraisal of the main macro-economic variables, there is a vital link between macro-economic policies and improvement of statistical services at sectoral and micro levels. A case in point is a country where a recent IMF programme fixed industrial productivity measures as a trigger for wage increases in the industrial sector. However, with the available equipment the statistical staff were not in a position to provide an accurate assessment of industrial productivity. UNIDO could have provided necessary assistance, if funding had been available.

14. Accurate statistical measurements also play a vital role in determining the competitiveness of the industrial sector and of individual firms within the sector. In a free market environment, competitiveness is one of the main pre-requisites for economic success providing firms with the potential to generate export revenue. Here again UNIDO can provide technical support in setting up data systems to assess competitiveness criteria.

15. UNIDO also assists developing countries in identifying the most cost-effective means of financing their industrial and technological development. Examples of such activities are: the UNIDO industrial investment programme (ibid., chap. IV, section A), the holding of an expert group meeting on the financing of technology in Latin America; the preparation of a guide to sources of financing for technology in Latin America (ibid., chap. IV, para. 48) and the holding of a symposium on the financing of the Industrial Action Programme for the Least Developed Countries (ibid., chap. III, para. 43).

16. Among the important changes introduced in 1994 to the organizational structure of UNIDO in 1994 was the creation of the Development Finance Institutions Unit within the Mobilization and Management of Financial Resources Division. The Unit promotes the implementation of programmes with the financial support of multilateral financial institutions such as the World Bank Group and regional development banks such as the African Development Bank, the Asian Development Bank, the Inter-American Development Bank and the European Bank for Reconstruction and Development. In those joint programmes specific and strategic efforts are made to offer more tailor-made financial schemes for industrial financing. Such schemes may include risk capital in the form of equity capital mobilization, longer term investment capital in the form of industrial loans or rescheduling of industrial loans to the financial sector of developing country members of these institutions, or new forms of meeting short-term working capital requirements of industrial companies through the involvement of national development financing companies, commercial banks or investment funds. It is intended to organize in 1995 at least two expert group meetings to define in close consultation with counterparts of development finance institutions new schemes and methods for industrial funds mobilization on "terms and conditions acceptable to developing countries", as recommended at many international meetings on the subject.

17. Equity finance, such as the foreign direct investment, joint ventures, leasing and many other financial innovations that are emerging in the international financial markets give foreign creditors a claim on the net return of the investments. Yet equity finance also often involves transfers of capital, coupled with technology, know-how and goods which, through spillover effects, may contribute to accelerate economic development. Although this type of finance is very appealing to the debtor country, the investment opportunity must be attractive enough to compensate the potential foreign investor for the risk element and to secure any outstanding claims.

18. UNIDO has closely followed the evolution of innovative measures and mechanisms for the mobilization of financial resources for industrial development (a detailed analysis of financial innovations for industrial development can be found in the Global Report 1991/92, ID/376, chap. IV). In the area of equity finance, UNIDO has identified venture capital funds, leasing and build-operate-transfer (BOT) as suitable vehicles for financing industrial development projects. Some of these funding mechanisms have been the subject of technical cooperation activities, e.g. assistance in the use of the BOT scheme (cf. GC.6/5-IDB.13/12, para. 45 and the preparation and circulation of a manual on BOT operations which provides interested parties with a practical source of information on this important financial innovation.

19. UNIDO is also able to provide direct assistance to development finance institutions, such as venture capital companies, through the provision of computer software and training to improve and streamline credit appraisal operations. In this respect, both the UNIDO Computer Model for Feasibility Analysis and Reporting (COMFAR) and the Project Profile Screening and Pre-appraisal Information System (PROSPIN) are appropriate and the Organization has recently been requested by the West African Development Bank to install these programmes at the Bank headquarters in Lomé and to provide training for both credit officers and trainers themselves in order to ensure the sustainability of the project.

III. ACTION REQUIRED OF THE BOARD

20. The Board may wish to take note of the present report.